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SUBJECT: Blow-by-Blow on Argentina's Nationalization of Pensions and Resulting Financial Panic

REF: (A) BUENOS AIRES 1466, (B) BUENOS AIRES 1442

Summary

¶1. (SBU) Argentine President Cristina Kirchner de Fernandez has justified the GoA's nationalization of Argentina's private pension system as a "rescue of retirees," although local analysts agree that the real reasons are financial. Under Judicial order, the pension funds were raided and blocked from making any transactions last week. They resume operations today, under close surveillance of the Superintendency of Pension Funds, and amid expressions of concerns that the funds' foreign assets may become attachable by holdout bondholders and reports that the GoA may order them to bring foreign assets home. The Argentine Congress begins deliberations on the nationalization October 29, and the GoA has expressed hopes of pushing it through by the end of November, if not sooner. Local and foreign economists and analysts have criticized the measure, calling it a blatant asset grab and a sign of GoA desperation for funds in order to meet spiking 2009 and 2010 debt maturities. The GoA intervened heavily in the markets last week to halt panic selling of Argentine stocks and bonds. The Central Bank (BCRA) also intervened heavily, selling dollars to bolster the peso. Nevertheless, the banking sector remains concerned about the possibility of large-scale capital outflows. Bank contacts expect greater GoA and BCRA intervention in the weeks to come. They argue that the markets read the GoA's action as a sign of dangerous fiscal weakening in the face of plummeting commodity prices and a rapidly decelerating economy, with some economists predicting recession in 2009. End Summary.

¶2. (U) This is a companion piece to Ref A, providing added detail about the GoA's decision to nationalize the private pension funds (known in Argentina as AFJPs), the market's fiercely negative reaction, and increasing concerns about economic and financial stability in Argentina going forward.

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President moves to nationalize private pension funds
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¶3. (SBU) In their October 21 formal announcement of plans to nationalize private pension funds (known locally as AFJPs), President Cristina Kirchner de Fernandez (CFK) and Amado Boudou, head of Argentina's Social Security System (ANSES), declared the "end of the failed private system," and characterized their

initiative as "the rescue of future retirees from uncertainty and bad management." Playing to traditional Peronist/statist supporters, Boudou noted that "some countries decide to rescue banks and companies, but the President chose to rescue regular people and retirees." Both he and CFK promised "predictability and sustainability" for future pensioners, and assured Argentines the GoA would use the nationalized funds responsibly.

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In the works for long time; global crisis gave excuse
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¶4. (SBU) Ambassador and EmbOffs have heard from contacts that the nationalization of AFJPs' $30 billion in assets has long been on the Kirchners' "to-do" list, but recent international market developments, and increasing concerns about the GoA's lack of access to sufficient funds to cover spiking debt payment obligations during 2009 and 2010, pushed it up on their agenda. Cabinet Chief Sergio Massa (who was head of ANSES from 2002 to 2007) and his close associate, current ANSES Director Amado Boudou, originated and developed the specific idea to nationalize the private pension system. However, former President Nestor Kirchner is reputed to have focused GoA attention on the nationalization concept by regularly asking for ideas to get more money into the public coffers to meet financing needs over the next several years, both for debt payments and to continue subsidies and public works in advance of the 2009 midterm elections. While Boudou, in recent interviews with media, stated that the GoA plans to use AFJP resources for public works and not directly for debt payments, budget monies are fungible.

Weak AFJP response

¶5. (SBU) As reported in Ref B on the concerns of the only U.S.-controlled AFJP (MetLife), the AFJPs as a group have not reacted strongly against the initiative. Indeed, AFJP contacts tell Post that there is a fierce debate ongoing between those few AFJPs that want to pursue a confrontational approach and the majority that are worn down by GoA interference in their businesses and just want to negotiate an acceptable exit. This resignation has been compounded by the aggressive judicial raids an Argentine judge ordered last week on all the AFJPs (reportedly at the request of the Casa Rosada).

¶6. (SBU) The ostensible purpose of the raids was to secure computer systems and information and check for fraudulent practices. However, MetLife officials note that the Superintendency of Pension Funds already had all of the information available, and numerous AFJP sources allege to Post that the real reason is to intimidate the AFJPs and their employees. The Judge also ordered a seven day freeze on AFJP transactions. (Comment: The AFJPs will likely all sue the GoA, if only to meet their fiduciary responsibilities. Many contributors will also likely file lawsuits. Moreover, the four foreign-owned AFJPs may eventually decide to seek redress under their countries' Bilateral Investment Treaties with Argentina. MetLife and HSBC, which runs the AFJP "Maxima," informed Econoffs that they will consider the advisability of ICSID arbitration after Congress passes the nationalization law and the GoA has clarified the compensation - if any - it is willing to pay.)

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Concerns about Asset Repatriation and Attachment
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¶7. (SBU) The AFJPs resume activity today under tight surveillance from the Superintendency of Pension Funds, headed by ANSES Director Boudou. Boudou has limited AFJP trading in currency and Argentine bonds until Congress passes the bill, and is also strictly controlling the AFJPs over USD 2 billion in term deposits in the local banking system. The AFJPs' ownership of billions in foreign stocks, mutual funds, bonds, and other securities (including holding significant equity positions in dozens of U.S. companies) has raised

questions about whether these foreign assets might be open to attachment by the so-called "holdout bondholders." Local media report that the GoA will require the AFJPs to repatriate their foreign assets. While this will imply billions in capital inflows, helping the BCRA to bolster the exchange rate, it is unclear whether foreign lawsuits could block these transfers (since AFJPs are still in private hands, but clearly following GoA instructions). The AFJPs also hold significant stakes in many local companies (including U.S.-origin companies), which has raised fears about increased GoA influence and perhaps direct intervention in the private sector. GoA sources have sought to downplay these fears, and Boudou has also stated that since ANSES is prohibited from holding more than 10% in any company, it will divest these excess shares over 4-5 years to meet the limit.

GoA Hopes for Quick Congressional Passage

¶8. (SBU) MetLife officials tell Post they are currently preparing to participate in the initial deliberations of the GoA's AFJP nationalization bill, beginning October 29 before the Chamber of Deputies' Budget committee. The AFJPs' Union (of which Met is a VP) will present the industry's view. According to October 27 press reports, the GoA is hoping to get the bill through the full Congress in November, despite growing signs of opposition (Ref A). Local media is reporting increasingly combative exchanges between GoA officials and opponents in Congress, with the GoA rejecting many of the changes to the bill that opponents in Congress are demanding. Most press commentators still seem to believe that at most the bill's opponents in Congress will only succeed in delaying it, and possibly modifying it somewhat, although the fight will clearly be tougher than GoA officials expected. (Comment: The Ambassador heard from sources over the weekend that the President instructed her Ministers Friday afternoon to get the AFJP bill passed as soon as possible and through the Chamber of Deputies by October 31. She and Nestor Kirchner are apparently worried about a drop in the value

of AFJP holdings, which is why they pushed for the judicial system to impose the restraining order on AFJPs' trading activities. They had originally hoped to get the bill through Congress in two weeks. Realizing that will not happen, they have imposed new restraints on AFJP operations from now on. End Comment).

Economists and Analysts highly critical

¶9. (SBU) In contrast to the AFJPs' relatively muted response, local and foreign economists and analysts have loudly criticized the measure, calling it a blatant asset grab and sign that the GoA is desperate to raise funds to pay 2009 and 2010 debt obligations and also to avoid cutting spending as the economy deteriorates and the 2009 mid-term elections near. The GoA's problem is twofold: lack of access to financing and expectations of lower revenues, both coinciding with a period of increasing financing needs. Argentine bond yields have skyrocketed in response to the global financial crisis, dashing the GoA's hopes of raising new cash through a debt deal with holdout bondholders or smoothing out the spike in amortizations during 2009-2011 through a mini-debt swap of bonds coming due during this period (see septel). (Current Argentine bond yields of well over 20% also likely eliminate the possibility of placing GoA debt with Venezuela anytime soon.) These circumstances, along with expectations of lower revenues going forward, lead all of Post's contacts (including at the BCRA) to conclude that the GoA's primary motivation for nationalizing the AFJPs is financial (and not to "rescue" retirees).

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GoA fumbles to respond to markets' negative reaction
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¶10. (SBU) The freefall in stock and bond prices October 21-22 in reaction to the GoA's announcement has created the most serious financial crisis since the 2001-02 financial meltdown. The Buenos

Aires stock market (Merval) dropped 20% between the open of trading October 21 and close of trading October 22, and at one point on October 22 hit a low 26% below the October 20 close. Argentina's country risk premium, as measured by JPMorgan's EMBI+, widened 575 basis points during the two days, closing on October 22 at 1,970 bps -- at one point exceeding 2,000 bps. The 5-year Credit Default Swap (CDS) for Argentina spiked up several thousand basis points to over 50% on October 22, as reported by Bloomberg. (Other estimates for CDS are in the 30% to 40% range, but the fact is that no one is closing CDS contracts at these levels, so the percentage is immaterial.)

¶11. (SBU) The BCRA maintained the peso at 3.24/dollar on October 22 through heavy selling of dollars on the spot and futures markets. Traders estimate spot market sales of $400 million on October 21 and $130 million on October 22. For the week, the peso depreciated 2%, closing at 3.29/dollar, despite continuing, strong BCRA intervention. Traders estimate that the BCRA sold more than $1 billion in reserves from October 20-24. There are strong signals that the market is expecting a significantly weaker peso going forward. The one-year NDF (non-deliverable forward contract, traded outside of Argentina) increased from 4.35 pesos/dollar on October 17 to 5.50 pesos/dollar on Oct 24, while the one-month NDF increased from 3.38 to 3.75 for the same period. In local currency trading, which the BCRA is able to manipulate by selling dollars forward, the one month contract is for 3.34 pesos/dollar and the one-year is 3.81 pesos/dollar.

¶12. (SBU) Local analysts believe that the GoA was caught completely off guard by the intensity of the adverse market reaction, and has since struggled to cobble together a coherent response. BCRA contacts confirm that the GoA reacted October 22 by buying both local bonds and stocks. This intervention seems to have succeeded in halting some of the panic-selling. The Merval was mostly flat October 23-24, and country risk tightened 185 basis points near the end of the week. (The Merval closed down 27% for the week, for an accumulated loss of almost 60% for year to date. The EMBI+ finished the week at 1,832 bps, still the highest point since the 2005 debt restructuring.) However, short-term bonds continued their free fall. In fact, Argentine Bonds had their worst week since the 2005 debt restructuring. USD bond prices dropped on average 35% from October 20-24, and benchmark bonds such as the Boden 2012, NY USD

Discount and NY USD Par decreased 28%, 39% and 11%, respectively (giving them yields of 60%, 30% and 17%, respectively).

¶13. (SBU) According to the press, the GoA is considering further "market-friendly" actions to counteract the negative perceptions of the AFJP nationalization. Banco Galicia's Chief Economist told Econoff October 23 that he expects the main thrust to be further GoA bond repurchases, but on a large scale. For HSBC's Chief Economist, GoA bond purchases are actually the "acid test" of whether the GoA is ready to prove its "willingness to pay" its debts. With bond prices at almost record lows, he believes it would be insane for the GoA not to buy back bonds (rather than wait until maturity). Both economists believe that done on a large scale, these repurchases would go a long way to calming market concerns about possible default during 2009 or 2010.

The specter of Recession in 2009 raises its head

¶14. (SBU) Markets are extremely nervous about expectations that the GoA's fiscal situation will weaken in the face of sharply lower prices for Argentina's main commodity exports and the rapid deceleration of the economy. For the first time, Post is starting to hear economists predict recession in 2009. Even before the GoA's decision to nationalize AFJPs, both Banco Galicia and HSBC lowered predictions for 2009 in response to falling commodity prices, expecting a 1-2% contraction in GDP. (Septel reports that BCRA President Redrado still expects economic output to stay positive in 2009.)

¶15. (SBU) Their main concern now is whether this latest crisis will

result in a large-scale capital outflows from the financial system. As of October 24, banks surveyed by Post report much higher than normal "dollarization" (conversion of peso deposits to dollar deposits and dollar purchases), but still below the worst days in April and May during the farm crisis. BCRA contacts insist that they can handle current levels of retail withdrawals. Large deposit withdrawals by institutions, though, would be cause for alarm, but are not a problem at present.

¶16. (SBU) Post's contacts contend that markets are also responding to the growing fear that anything is possible now and no sector is immune from GoA intervention. While agreeing that the AFJP nationalization most likely reduces the risk of default over the next few years, Post's contacts worry about its medium-term impact on the economy. AFJPs collectively have been the largest institutional investor in Argentina. Without them, competition will increase for scarce bank lending and GoA lines of financing, potentially crowding out SMEs from credit markets, further concentrating lending under state-owned banks (the two largest state-owned banks already provide over 20% of total credit to the market), and exacerbating the economic downturn. In the face of this probable credit crunch, banks now worry they may be the GoA's next target. Sourcing many of Post's closest banking sector contacts, an October 22 Cronista article raises the concern that the GoA may respond to the unavailability of credit by relying on traditional Peronist interventionist policies (of the 1970s), e.g., capping interest rates, forcing lending, putting sharper controls on capital flows, and having official and parallel exchange rates.

Comment

¶17. (SBU) Several private sector contacts have argued to Ambassador that, in many ways, the global economic crisis has helped the Kirchners: 1) inflation is moderating; 2) energy use is not growing and will likely stay flat with lower economic activity, thus helping to avoid energy cuts to consumers and allowing the GoA to reduce energy subsidies; 3) unions have backed off demands for wage increases; 4) the GoA has a plausible excuse to pursue policies that please its political base (e.g., protectionist trade measures, nationalization of AFJPs); and 5) the crisis gives the government a nationalistic rational with which to slap out at criticism from the opposition. However, such relief comes at a price: a potentially steep recession just prior to mid-term legislative elections. The GoA's ill-considered decision to nationalize AFJPs will only accelerate the likelihood of a precipitous downturn, even if many in

the GoA relish the possibilities of launching big new public works programs given extra cash. Banco Galicia's Chief Economist told Econoff that Cabinet Chief Sergio Massa initially was considering using a sharp devaluation of the peso as the means to maintain competitiveness and protect the fiscal surplus (and avoid default in 2009), and he consulted numerous economists and bankers on this policy option. However, former President Nestor Kirchner reportedly nixed the deal, worried that the devaluation would lead to a spike in inflation and renewed union demands for wage increases, which in his mind was unacceptable prior to the 2009 mid-term elections. This led Massa to pursue Option 2: AFJP nationalization.

WAYNE